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A RESPONSE TO GAO'S CRITICISMS OF STATE FISCAL GRANTS

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In a letter to Senate Budget Committee Chairman Nickles last week, the General Accounting Office expressed several criticisms of the program of direct, flexible grants to states that was enacted in May 2003. These temporary grants, totaling $10 billion, were enacted as part of the Jobs and Growth Tax Relief Reconciliation Act of 2003 and were disbursed in July and October 2003. Together with a similar amount of additional federal funding through the Medicaid program, these grants were intended to help states maintain programs and balance their budgets during the prolonged fiscal crisis.

Key Findings

GAO's recent letter fails to prove its claim that the fiscal relief payments to states in 2003 occurred too late and were poorly targeted.

If GAO had examined states' uses of fiscal relief more thoroughly, it would have found examples from across the country in which these funds averted even deeper cuts in core services like education and health care.

Because fiscal relief constituted just a fraction of states' budget shortfalls, it is highly unlikely to dissuade states from preparing for future downturns.

GAO's principal criticisms are that the grant payments occurred too late in the economic downturn, that they were not well-targeted to the neediest states, that it is hard to know exactly how states spent the money, and that they may discourage states from reserving funds in anticipation of the next economic downturn. Further, Sen. Nickles used the GAO letter to suggest that recent tax cuts have been more effective than the state fiscal relief in improving the economy.

Although the grants program is ending this year as scheduled, GAO's criticisms are important to consider because they could shape federal responses in a future economic slump. Unfortunately, the GAO letter provides little fresh information on the actual impact of this program; it is based largely on analyses of the 1970s era program of aid to the states and cursory interviews with officials in 12 states. Moreover, Senator Nickles' contention that the tax cuts were more effective is not supported by the GAO correspondence (or any other evidence). In fact, it is very likely that the federal grants to states averted deep and painful spending cuts and/or tax or fee increases in many states.

A broader analysis would have found at a minimum that the fiscal relief dollars — both the flexible grants and the enhanced Medicaid funds — allowed such states as Massachusetts, Minnesota, Missouri, Montana, New Jersey, Ohio, and South Carolina to maintain health coverage for hundreds of thousands of children, parents, seniors, and people with disabilities; allowed states like Arkansas, Louisiana, Missouri, and Nevada to avert K-12 education spending cuts or meet education mandates; and allowed states like Alaska, Arizona, Colorado, and West Virginia to maintain social services programs, among other impacts. In short, there can be little doubt that without the federal funds, the reduction in general-fund spending — and hence large spending cuts to education, health care and other essential state services — would have been greater.

This analysis addresses the four major criticisms leveled in the GAO letter (GAO-04-736R) concerning the timeliness, the targeting, the use of the funds, and the impact on future state saving. A forthcoming CBPP analysis will explore in more detail the impacts of the federal fiscal relief on states.

The Grants to States Were Timely

In the spring of 2003, when the grants were enacted, states were facing approximately $25 billion in budget shortfalls for state fiscal year 2003 and an additional $75 billion in budget shortfalls for 2004. The shortfalls existed even though, in the two years since the recession began, states had cut spending by tens of billions of dollars and had raised fees and taxes to significant degrees. States' reserve funds, which reached a record level of 10.4 percent of their budgets in the 1990s, were largely exhausted. Additional such spending cuts and revenue increases a number of states were contemplating at the time would have hurt families already struggling in the aftermath of the recession. Moreover, many economists agreed that additional state spending cuts or tax increases would take dollars out of state economies and therefore could further slow the economic recovery.

GAO's letter says the grants were probably not "ideally timed" because the first grants were distributed in July 2003, 19 months after the official end of the recession. GAO does not indicate what it believes ideal timing would have been. In fact, state budget problems were worse in fiscal years 2003 and 2004 — as measured by the size of aggregate budget shortfalls — than they had been in 2001, despite the fact that the economy was officially in recovery. National employment was lower in 2003 than it had been in 2001, and roughly 30,000 jobs were being lost per month when the grants were enacted.

Not until *after* the second round of grants to states was made available in October 2003 did employment levels finally begin to rise and many states begin to meet their revenue targets. Indeed, a substantial number of states *still* face fiscal problems. Thus, although state fiscal grants provided earlier could have been helpful, it is incorrect to suggest they were too late to boost the economy, help states, and avert painful budget actions.

The timing of the grants to states — in July and October 2003 — looks even better when it is contrasted with the timing of the $330 billion in federal tax cuts enacted in the same legislation. By October 2003, when the second and final round of grants to states was issued, only about one-sixth of the enacted tax cuts were in the hands of taxpayers. This is because several of the tax cut provisions were phased in over time. In fact, a large portion of the tax cuts

— 43 percent — will not be disbursed until October 2004 or later, according to the Joint Committee on Taxation. Compared with the tax cuts, the grants to states clearly were distributed in a much more timely manner, suggesting they were *more* effective in stimulating the economy — not, as Senator Nickles suggests, less effective.

It is also worth noting that grants to states were actually proposed much earlier in Congress — as early as the fall of 2001 — but delayed by opposition from both the White House and certain members of Congress including Senator Nickles.

The Targeting of the Grants Was Reasonable

Most of the $10 billion in grants were disbursed on a straightforward per-capita basis.[1] GAO indicates that the failure to target the grants to the states hit hardest by the fiscal crisis and the recession was "from an economic perspective … less than optimal." But while the lack of targeting perhaps can be criticized on equity grounds, it probably had little impact on the effectiveness at alleviating the fiscal crisis and helping the economy. This is because nearly every state was hit hard enough to warrant substantial federal aid. In the great majority of states, the grant from the federal government covered only a portion of the 2003 and 2004 budget shortfalls that states needed to address. Because the needs exceeded the grants, each dollar of grants to states could be used to eliminate the need for a dollar of spending cuts or a dollar of tax or fee increases at the state level – exactly as economists said the grant program should work to stimulate the economy.

It is also worth noting that the other half of the state fiscal relief package enacted in May 2003 — an estimated $10 billion in temporary enhanced federal matching funds for Medicaid, which was not studied by GAO — did contain a substantial degree of targeting. By definition, those funds were targeted to help states cope with increasing health care costs due to rising Medicaid enrollment as families lost their jobs and health insurance. In fact, states could only access the enhanced federal matching funds if they agreed to maintain their Medicaid eligibility levels and thus used the grants for incremental costs. All the states accepted those additional matching funds and abided by the eligibility requirement.

Again, the tax cuts enacted as part of the same 2003 bill serve as a contrast. In order to most efficiently stimulate the economy, the tax cuts should have been targeted to low- and middle-income families who would have been most likely to spend the money immediately. Instead, according to the Tax Policy Center, some 78 percent of those tax cuts are going to the wealthiest 20 percent of U.S. taxpayers — those who are *least* likely to spend the money and therefore boost the economy. By both the timeliness standard and the targeting standard, the fiscal relief was more effective than the tax cuts.

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[1] A few small states received particularly large grants on a per-capita basis because they benefited from a provision in the law requiring every state to receive at least $50 million. Without this provision, for example, the nation's least populous state, Wyoming, would have received only $17 million. GAO depicts this aspect as a significant inequity, but the $50-million minimum had virtually no effect on the grants to other states. Without the $50-million minimum, larger states would have seen their grants increased by about three percent — hardly a major impact on the program's effectiveness.

How Were the Grants Spent?

GAO conducted what appears to have been a cursory set of interviews with budget officials in 12 states and was unable to determine in substantial detail how states have spent the flexible grant funds. This is because the federal funds in most cases were commingled with states' own funds before being expended. The commingling, however, does not in any way demonstrate that the money was not put to good use. Most states placed the funds in their general funds, which primarily pay for education, health care, and public safety. State general-fund budgets were hard-hit by the economic downturn and have declined in real per-capita terms in each of the years of the fiscal crisis.

The GAO also did not examine the severity and types of spending cuts states actually instituted due to their budget deficits over the last two years or the cuts they were considering prior to enactment of the fiscal relief provisions.[2] It also did not examine whether various proposed state spending cuts were averted or limited in the 12 states after the fiscal relief funds became available, or whether states were able to avoid fee and tax increases.

Had GAO conducted a more in-depth comparison of proposed and enacted spending cuts and tax increases in the 12 states studied, or if it had studied more states or expanded its analysis to include the $10 billion in enhanced Medicaid funds, it would have found more examples of positive impacts from the fiscal relief package. A review of budget documents and public statements by state officials suggests that the 2003 fiscal relief package helped many states avert cuts in health care, education, human services, and other areas. Families in states across the country have been hurt by the fiscal crisis; without the grants, the hardships would have been magnified.

The Grants' Impact on State Saving

GAO contends that the enactment of these grants could make states "less apt" to save for the next recession. But the letter gives no direct evidence for this assertion; for instance, GAO does not appear to have asked state budget directors whether they expected federal aid in the future.[3]

There are several reasons to doubt GAO's warning that the grants program will undermine future state savings. At the time of enactment, Congress made quite clear that the grants program was one-time in nature, a response to a fiscal crisis that by many measures was the worst since the Great Depression. Further, the $20 billion in combined grants to states and Medicaid enhancements was quite small relative to the roughly $230 billion in cumulative

[2] Evidence of the severity and types of spending cuts enacted since 2002 may be found in a series of Center on Budget and Policy Priorities reports at http://www.cbpp.org/statecrisis.htm.
[3] GAO attempts to draw an analogy to federal emergency aid to states for natural disasters such as forest fires, but the analogy is not apt. Federal disaster aid is disbursed on an annual basis, and even emergency supplemental appropriations occur in many years, so states have learned to expect them.

budget gaps that states faced over the course of the fiscal crisis. States would be hard put to view these modest grants as a bailout or interpret them as providing a substitute for rainy day fund accumulations.[4]

In the years before the recession, states saved a total of roughly $50 billion in rainy day funds and other general-fund reserves. The GAO letter implies that the $20 billion in grants would create a "moral hazard" that would tempt states to reduce their savings by a comparable amount. In fact, if states base future savings on their experiences in this fiscal crisis, they are likely to save *more* in the future, not less, because the combined amount of federal relief and states' own savings fell far short of the multi-year budget gaps that states faced.

In fact, federal actions taken as a whole during this fiscal downturn — ranging from elimination of the state estate tax credit, to enactment of new unfunded mandates, to restrictions on state authority to tax Internet access — have worsened, not improved, states' financial conditions, costing states some $155 billion in the fiscal year 2002-05 period, even after accounting for the $20 billion in federal fiscal relief enacted in 2003.[5] In addition, the size and projected growth rate of federal budget deficits should provide a strong indication to states that they cannot rely on the federal government for future assistance. If anything, the federal policies of the past several years are likely to be driving states to save more, not less, for future fiscal crises.

[4] It is also worth noting that this last criticism by GAO is entirely inconsistent with the first two criticisms. If, as GAO contends, the grants to states came too late to be helpful and failed to go where they were needed, then it is unclear why states would expect the federal government to provide timely and well-targeted grants in the next economic downturn.

[5] Iris J. Lav and Andrew Brecher, *Passing Down The Deficit: Federal Policies Contribute To The Severity Of The State Fiscal Crisis*, http://www.cbpp.org/5-12-04sfp.htm.